Supreme Court, U.S.
FILED
JUN 3 1971
E. ROBERT SEAVER, CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1970.

No. ~~1222.~~ 70-79

RELIANCE ELECTRIC COMPANY,
Petitioner,

v.

EMERSON ELECTRIC COMPANY,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

BRIEF FOR PETITIONER.

THOMAS P. MULLIGAN,
PATRICK J. AMER,
1750 Union Commerce Building,
Cleveland, Ohio 44115,

STEPHEN J. BURNS,
24701 Euclid Avenue,
Cleveland, Ohio 44117,

KENNETH S. TEASDALE,
611 Olive Street,
St. Louis, Missouri 63101,
Counsel for Petitioner.

Of Counsel:
JONES, DAY, COCKLEY & REAVIS,
ARMSTRONG, TEASDALE, KRAMER & VAUGHAN.

THE GATES LEGAL PUBLISHING CO., CLEVELAND, OHIO—TEL. (216) 621-5647

TABLE OF CONTENTS.

OPINIONS BELOW 1

JURISDICTION 1

STATUTE INVOLVED 2

QUESTION PRESENTED 3

STATEMENT OF THE CASE 3

SUMMARY OF ARGUMENT 6

ARGUMENT 7

I. The Two-Step Sales Technique Is a Form of Stock Disposition Which Lends Itself to the Speculative Abuse Section 16(b) Was Designed to Prevent 7

II. Section 16(b)'s "Arbitrary Standards" Do Not Preclude Analysis of the Potential for Abuse in the Factual Situation and Broad and Remedial Construction of the Terms of the Statute 12

III. The Exemptive Provision in Section 16(b) Does Not Exempt the Second of Two Sales Effected Pursuant to a Single Pre-Determined Plan of Disposition 18

A. Emerson's Two Sales Are To Be Treated as One "Sale" Under Section 16(b) 19

B. Section 16(b) Should Apply to Both of Emerson's Sales Transactions Under Substance Over Form Principles and the Step Transaction Doctrine 23

IV. Section 16(b) Should Be Construed as Broadly as Possible to Maintain Fiduciary Standards 28

CONCLUSION 30

TABLE OF AUTHORITIES.

Cases.

Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570 (S.D.N.Y. 1970) 9, 21

Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) 16, 17

Alaska Industrial Bd. v. Chugach Electric Ass'n, 356 U.S. 320 (1958) 8

American Bantam Car Co., 11 T.C. 397 (1948), *affirmed*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950) 25

Anheuser-Busch, Inc. v. Helvering, 40 B.T.A. 1100 (1939), *affirmed*, 115 F.2d 662 (8th Cir. 1940), *cert. denied*, 312 U.S. 699 (1941) 25-26

Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971) 14, 20, 21

Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) 7, 9

Blau v. Lehman, 368 U.S. 403 (1962) 14, 28

Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) 10-11, 15

Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967) 14

Colby v. Klune, 178 F.2d 872 (2d Cir. 1949) 14

Commissioner v. Gordon, 391 U.S. 83 (1968) 26

Crowell-Collier Publishing Co., The, Securities Act Release No. 3825 (1957), 1957-61 CCH Fed. Sec. L. Rep. ¶ 76,539 26

Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) 14, 15

Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959) 19

Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951) ---- 28

Great Sweet Grass Oils Ltd., 37 S.E.C. Reports 683 (1957), *affirmed*, 256 F.2d 893 (D.C. Cir. 1958) 26

Gregory v. Helvering, 293 U.S. 465 (1935) ---- 24

King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) ---- 25, 26

LeTulle v. Scofield, 308 U.S. 415 (1940) ---- 8

Loewi v. Ryan, 229 F.2d 627 (2d Cir. 1956) ---- 12

Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928) ---- 28

Newmark v. RKO General, Inc., 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970) ---- 9, 20

Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir.) *cert. denied*, 332 U.S. 761 (1947) ---- 21

SEC v. Micro-Moisture Controls, Inc., 148 F. Supp. 558 (S.D.N.Y. 1957), *affirmed sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959) ---- 26

Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943) ---- 10, 28, 29

Stella v. Graham-Paige Motors Corp., 132 F. Supp. 100 (S.D.N.Y. 1955), *affirmed in part*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956) 22

Truncale. v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948) ---- 15

United States v. General Geophysical Co., 296 F.2d 86 (5th Cir.), *rehearing denied*, 62-1 U.S.T.C. ¶ 9115 (5th Cir. 1961), *cert. denied*, 369 U.S. 849 (1962) ---- 26

Volk v. Zlotoff, 285 F. Supp. 650 (S.D.N.Y. 1968) 28

Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966) ---- 11, 13, 28

Statutes.

Securities Exchange Act of 1934:

Sec. 10(b) ---------- 10

Sec. 16(a) (15 U.S.C. § 78p(a)) ---------- 2

Sec. 16(b) (15 U.S.C. § 78p(b)) ---------- 2, *et passim*

Sec. 27 (15 U.S.C. § 78aa) ---------- 4-5

28 U.S.C. § 1254(1) ---------- 1

28 U.S.C. § 1292(b) ---------- 5

Other.

Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 555, 605, 629 (2d Ed. 1966) ---------- 24

General Rules and Regulations under the Securities Exchange Act of 1934, Rule 10b-5 ---------- 10

II Loss, *Securities Regulation* 1087, 1043 (1961) ---- 11

Seligman, "Problems Under the Securities Exchange Act," 21 *Va. L. Rev.* 1, 20 (1934) ---------- 18

Supreme Court Rules 40(1)(d)(2), 40(3) -------- 8

In the Supreme Court of the United States

OCTOBER TERM, 1970.

No. 1332.

RELIANCE ELECTRIC COMPANY,
Petitioner,

v.

EMERSON ELECTRIC COMPANY,
Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

BRIEF FOR PETITIONER.

OPINIONS BELOW.

The opinion of the United States Court of Appeals for the Eighth Circuit, filed on November 12, 1970, is reported at 434 F.2d 918 (A. 170). The memorandum opinion of the United States District Court for the Eastern District of Missouri, filed on September 18, 1969, is reported at 306 F. Supp. 588 (A. 157).

JURISDICTION.

The judgment of the United States Court of Appeals for the Eighth Circuit was entered on November 12, 1970. The petition for writ of certiorari was filed on February 9, 1971, and was granted on April 5, 1971. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTE INVOLVED.

The relevant portions of the text of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), are as follows:

> Section 16(b). For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner [the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title],[1] director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

---

[1] The bracketed words are taken from Section 16(a) of the Securities Exchange Act of 1934, 78 Stat. 579, 15 U.S.C. § 78p(a).

QUESTION PRESENTED.

May the beneficial owner of more than 10% of an issuer's stock, desiring to sell all of its stock of the issuer at a profit within six months of the purchase of such stock, insulate from Section 16(b) of the Securities Exchange Act of 1934 and retain for its own benefit the short-term profits on 9.96% of such stock by effecting its single predetermined plan of disposition through the technique of two sales, the first of which reduces the beneficial owner's holdings to 9.96%, and the second of which disposes of the balance?

STATEMENT OF THE CASE.

On June 16, 1967, pursuant to a tender offer for shares of Dodge Manufacturing Company ("Dodge"), Emerson Electric Company, respondent herein ("Emerson"), purchased 152,282 shares of Dodge stock at $63 per share (A. 15). These shares constituted 13.2% of the then outstanding Dodge common stock (A. 17). Prior thereto, Emerson had owned no shares of Dodge common stock (A. 15).

On or about June 1, 1967, Dodge entered into an agreement to merge Dodge into Reliance Electric Company,[2] petitioner herein ("Reliance") (A. 157-58). On June 17, 1967, Emerson told Dodge it intended to solicit proxies for the August 22, 1967 Dodge shareholders meeting in opposition to the merger (A. 103). Under date of June 26, 1967, Emerson's general counsel sent Emerson

---

[2] On March 3, 1969, The Reliance Electric and Engineering Company, an Ohio corporation, changed its name and its state of incorporation by merging into its wholly-owned subsidiary, organized for that purpose, Reliance Electric Company, a Delaware corporation. All of the business and assets of Reliance of Ohio, and all of its liabilities and obligations, became those of Reliance of Delaware by operation of law.

a letter discussing alternatives to the proxy contest with Reliance. This letter discussed "principally, how to dispose of, at a profit, the shares of Dodge stock which Emerson now owns," and outlined a plan of "defensive action against 16(b) possibilities" (A. 33-38).

At the Dodge shareholders meeting on August 22, 1967, the Dodge shareholders approved the merger of Dodge into Reliance (A. 65). Shortly thereafter, pursuant to counsel's plan, Emerson negotiated a sale by Emerson and purchase by Goldman, Sachs & Co. of 37,000 shares of Dodge common stock at $68 per share (A. 16). The agreement of sale was made on August 28, 1967; Emerson delivered the subject shares to Goldman, Sachs on August 29, and received payment on September 1 (A. 16). Emerson's remaining 115,282 shares constituted 9.96% of the then outstanding Dodge common stock (A. 17).

On August 29, 1967, Reliance, on behalf of Dodge, initiated discussions with Emerson with respect to the purchase of the remaining 115,282 shares of Dodge common stock (A. 16). On September 5, 1967, Emerson agreed to sell and Dodge agreed to buy the 115,282 shares at $69 per share; a purchase agreement effecting this sale was executed on September 11, and the closing thereunder took place on September 13, 1967 (A. 17). On September 29, 1967, Dodge merged into Reliance (A. 18).

On February 29, 1968, Emerson filed a petition for declaratory judgment in the United States District Court for the Eastern District of Missouri (the "District Court"), asking that the court determine and declare the liability, if any, of Emerson to Reliance for the amount of the profits realized by Emerson for the two sales of Dodge stock described above (A. 3). Jurisdiction of the District Court was based on Section 27 of the Securities Exchange

Act of 1934 (15 U.S.C. § 78aa), and upon diversity of citizenship and amount. In trial on the issue of liability alone, the District Court determined that Emerson is liable to Reliance for the net profits realized by it from the sales of all 152,282 shares of stock of Dodge, for the reasons set forth in its Memorandum Opinion filed September 18, 1969 (A. 157).

The United States Court of Appeals for the Eighth Circuit (the "Eighth Circuit") granted Emerson's petition for leave to take an interlocutory appeal under 28 U.S.C. § 1292(b) (A. 169). The Eighth Circuit accepted the findings of the District Court set forth below, but held that as a matter of law Section 16(b) does not apply to Emerson's profits on the second sale (A. 179-82).

The relevant and undisturbed findings of the District Court were (1) "Emerson's initial sale of 37,000 shares was motivated solely by its desire to reduce its holding to just under 10% immediately prior to disposing of the balance of its shares in an attempt to escape Section 16(b) liability on the short-swing profits it contemplated would be made on such remaining shares"; (2) ". . . that although the two sales of Dodge stock were technically separate transactions and the second sale was not 'legally' tied in any way to the first sale, the two sales were effected pursuant to a single pre-determined plan of disposition with the overall intent and purpose of avoiding Section 16(b) liability"; and (3) that ". . . the obvious substance of the transaction as to a whole is the disposition of its [Emerson's] more than 10% beneficial interest" (A. 163-64).

SUMMARY OF ARGUMENT.

The two-step sale procedure used by Emerson and approved by the Eighth Circuit is a technique by which a 10% beneficial owner can take short-term profits whenever the opportunity arises. As such, it is the kind of transaction which lends itself to abuse of the fiduciary duty which Section 16(b) imposes upon every insider subject to its regulation. As the two-step sale procedure is a planning technique readily adaptable to nearly every disposition of stock by a 10% beneficial owner, the integrity of Section 16(b) will be materially impaired if the decision below is allowed to stand.

The Eighth Circuit based its holding on its view that Section 16(b) sets forth "arbitrary standards enacted by Congress" which require extremely literal application. In so holding, it erred, for it failed to apply to Emerson's two-step sale procedure those judicially-approved standards of construction of Section 16(b) which require (i) that the facts of the transaction before the court should be analyzed with a view to discerning their substance, and their potential for abuse as a means of taking insider profits, and (ii) that the terms used in Section 16(b) should be defined broadly and remedially, and strictly against the insider, with a view to the consequences of the decision in furthering the statutory purpose.

Emerson's two dispositions of Dodge stock were separate under local law, but were interrelated parts of a single plan to dispose of all of Emerson's holdings in an attempt to avoid Section 16(b). The characterization of a transaction under local law does not conclude its characterization under Section 16(b). The two-step sale procedure, united in purpose and intent, should be treated as one "sale" under Section 16(b). Emerson thus will have been a 10% beneficial owner "at the time of" its sale of all its Dodge stock.

Section 16(b) is to be applied to the substance, rather than to the form, of the transactions in question. The District Court found that "the obvious substance" of Emerson's transaction was the disposition of its entire holdings of Dodge stock. Emerson should not be permitted to separate its integrated disposition of Dodge stock into two steps so as to escape a liability under Section 16(b) which would attach if the disposition had been accomplished in one step.

By purchasing 13.2% of the stock of Dodge, Emerson assumed fiduciary responsibilities toward Dodge. Emerson profited substantially from short-term trading in the stock of its *cestui que trust*. All such profits should inure to the issuer. To prevent a lowering of fiduciary standards, the decision of the Eighth Circuit as to Emerson's second sale should be reversed.

ARGUMENT.

I. THE TWO-STEP SALES TECHNIQUE IS A FORM OF STOCK DISPOSITION WHICH LENDS ITSELF TO THE SPECULATIVE ABUSE SECTION 16(b) WAS DESIGNED TO PREVENT.

As its preamble states, Section 16(b) was intended by Congress to prevent the unfair use of information by statutory insiders—directors, officers, and 10% beneficial owners—in trading in the issuer's securities. The "uncommon regulatory mechanism" by which Section 16(b) operates to achieve this legislative intent in "relatively automatic" fashion is to make recoverable by the issuer *any* profit by the insider from *any* purchase and sale within a six-month period. *Blau v. Lamb*, 363 F.2d 507, 515-16 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). Within the statutory guidelines, Section 16(b) has been construed as broadly as possible to extend to every kind

of transaction in which inside information could possibly have been used by an insider to make short-term profits.

While Emerson was a statutory insider, the owner of 13.2% of Dodge shares, it determined to dispose of its entire interest in Dodge. In an attempt to "avoid the consequences" of Section 16(b) (A. 164) and retain the major portion of its substantial short-term profits in Dodge stock, Emerson sold just enough shares to bring its holdings under 10%[3], and promptly thereafter sold the balance of its holdings in a separately negotiated sale to a different buyer, Dodge. In less than three months Emerson, a statutory insider, had made over $900,000, less allowable expenses, by trading in Dodge stock. The Eighth Circuit, reversing the District Court, decided below that Emerson's attempt to "avoid the consequences" of Section 16(b) was successful, and that Emerson may retain its profits on the second sale.[4]

Prior to the decision of the Eighth Circuit in the instant case, no federal court had ever approved a technique by which a statutory insider could so shape his transactions in his issuer's shares as to insulate from Section

---

[3] Emerson's counsel had recommended, as "the initial defensive step," the sale of 37,100 shares of Dodge stock (A. 36). An increase in the number of Dodge shares outstanding between June 16 and August 22 permitted Emerson to follow the plan by selling only 37,000 shares, reducing its holding to 9.96% (A. 163).

[4] The Eighth Circuit also decided, affirming the District Court Court on this issue, that the purchase by which Emerson became a 10% beneficial owner is to be counted in determining liability under Section 16(b). As Emerson did not cross-petition for certiorari, that portion of the decree below which was decided adversely to Emerson is not before this Court. *Alaska Industrial Bd. v. Chugach Electric Ass'n*, 356 U.S. 320 (1958); *LeTulle v. Scofield*, 308 U.S. 415 (1940). As the legal issue involved in Emerson's purchase was not raised as a Question Presented in the Petition for Writ of Certiorari, it is not to be briefed or argued by the parties. Supreme Court Rules 40(1)(d)(2), 40(3).

16(b) a substantial portion of profits realized by him from stock purchases and sales within a six-month period. Now, for the first time in the history of decisions under Section 16(b), short-term profits may be made, and kept, by an insider who follows what the District Court called the "two-step sale procedure" (A. 164) used by Emerson and approved by the Eighth Circuit.

In the recent decision of *Abrams v. Occidental Petroleum Corp.*, 323 F. Supp. 570 (S.D.N.Y. 1970), Occidental was held liable under Section 16(b) for about $17,700,000 of short-term profits in the purchase and sale of shares of Kern County Land Company. If Occidental had followed the two-step sale procedure used by Emerson, and had entered into two option agreements with different optionees on different days, pursuant to its plan of disposition, Occidental would have insulated from recovery, by means which the Eighth Circuit permits, more than $8,600,000 of its short-term profits in Kern County stock. If the Eighth Circuit's decision is affirmed, well-advised insiders will not repeat the tactical error made by Occidental, and the two-step sale technique will become the "standard operating procedure" in every short-term disposition of stock by a 10% beneficial owner.

The initial inquiry in applying Section 16(b) is always whether the transaction in question "could possibly tend to accomplish the practices Section 16(b) was designed to prevent." *Blau v. Lamb, supra*, 363 F.2d at 519; *cf. Newmark v. RKO General, Inc.*, 425 F.2d 348, 351 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970). If Emerson had possessed inside information just prior to August 28, 1967, when it owned 13.2% of Dodge stock, could both the first sale *and* the second sale have been apt vehicles for taking short-term profits on that information? Clearly so. A sale for cash is always an apt vehicle for taking

profits; and inside information may give an insider an unfair advantage which lasts for several weeks.

If the Eighth Circuit's decision is affirmed, Emerson's two-step sale procedure can be used by any 10% beneficial owner at any time to make and keep short-term profits based on actual use of inside information.[5] The technique can be illustrated as follows: If Jones, the owner of 15% of the stock of X Corporation, learns by virtue of his position as an insider that at a directors' meeting two weeks hence the quarterly dividend will be reduced, Jones can thereupon, pursuant to a plan, sell 5.1% of his stock, wait a few days, and then sell the remaining 9.9%. After the directors have met and lowered the dividend, and the market has responded to the news, Jones can repurchase his 15%. Under the rule set forth by the Eighth Circuit in the decision below, Jones will be liable for only a little over one-third of his short-term profits, the profit on the sale and repurchase of 5.1% of the stock, to X Corporation, and will pocket his short-term profits on the remaining 9.9% free from Section 16(b).

Section 16(b) has been applied to a variety of transactions which, though found to be capable of insider abuse, could not have been availed of readily as a means of Section 16(b) avoidance. For example, the second closing under an agreement to sell a business entered into three years before does not suggest itself as a practical

---

[5] The fact that there may be a cause of action against such an insider using the two-step sale procedure under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder does not provide an adequate substitute for a deficiency in Section 16(b), for the plaintiff in a Rule 10b-5 suit has the burden of showing actual abuse of inside information. Section 16(b), with its automatic "rule-of-thumb" operation, was enacted precisely to eliminate this often very difficult burden of proof. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

planning device for avoiding Section 16(b) liability, *Booth v. Varian Associates*, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). Neither does the sale of one's entire stock holdings pursuant to an anti-trust consent decree, *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). Yet in both cases Section 16(b) liability was imposed because insider abuse was possible. In contrast, the two-step sale procedure, if it stands, will be a technique readily applicable in nearly every 10% beneficial owner situation; *a fortiori*, Section 16(b) liability should be imposed on both of Emerson's sales.

In the entire Securities Exchange Act of 1934, Section 16(b) has been perhaps the most "cordially disliked" provision, II Loss, *Securities Regulation* 1087 (1961); yet it "has undoubtedly had a substantial deterrent effect." *Id.* at 1043. A major reason for the great deterrent effect of Section 16(b) has been the well-founded belief of corporate insiders that no "technique" or method of framing their transactions will permit them to retain profits on sales of shares acquired within six months. The decision below establishes for the first time a significant exception to this rule, because it approves a technique, Emerson's two-step sale procedure, whereby a 10% beneficial owner can readily take short-term insider profits at will.[6] The

---

[6] The Eighth Circuit based its holding in part upon its statement that "there is no reason why a person may not conduct his business in such a way as to *intentionally minimize or eliminate his loss of profits* under Section 16(b) by any means permitted by law." (A. 180; Emphasis added.) First, the statement is question-begging: "It begs the question to say that a taxpayer has the legal right to decrease, by means which the law permits, the amount of what would otherwise be his taxes. The question here is whether the statute does permit a taxpayer to reduce his taxes by the means the taxpayer here employed." *Loewi v.*

(*Continued on following page*)

effectiveness of Section 16(b) as a standard of conduct for corporate insiders will be materially impaired if this Court permits the decision below to stand. The decision of the Eighth Circuit on Emerson's second sale should be reversed.

II. SECTION 16(b)'s "ARBITRARY STANDARDS" DO NOT PRECLUDE ANALYSIS OF THE POTENTIAL FOR ABUSE IN THE FACTUAL SITUATION AND BROAD AND REMEDIAL CONSTRUCTION OF THE TERMS OF THE STATUTE.

The last sentence of Section 16(b) contains the following exemptive provision:

> This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved . . . .

The Eighth Circuit held that Emerson's second sale "literally" fell within this exemption (A. 181) and felt itself unable to construe the exemption otherwise. The Eighth Circuit based its concededly literal construction of Section 16(b) on its view that the section contains "arbitrary standards enacted by Congress" and so requires extremely literal interpretation. The Court stated that (A. 181):

> The standards set forth in Sections 16(a) and 16(b) are arbitrary both in the selection of time, 6 months, and the selection of amount, more than 10 percentum. A security transaction either falls within or without

---

(*Continued from preceding page*)

Ryan, 229 F.2d 627, 630 (2d Cir. 1956) (Frank, J., dissenting). Second, and more important, the favorable attitude toward intentional preservation by an insider of his short-term profits which the Eighth Circuit here expressed stands in startling contrast to the attitude expressed by federal courts in nearly every significant prior decision construing Section 16(b).

> the scope of Section 16(b) depending on whether these arbitrary standards are met. (Footnote omitted.)

Based on this analysis, the Eighth Circuit did not consider whether Emerson's two-step sale procedure contained a potential for abuse of Section 16(b) which should not be permitted, or whether a remedial construction of Section 16(b) in light of the legislative purpose did not require more than an arbitrary and literal application of its terms. Having so handicapped itself, the Eighth Circuit was unable to correct the very abuse it recognized when it stated (A. 179): "In *less than three months* from its stock purchase Emerson apparently *had made substantial short-term profits* related to its stock acquisition activities in its efforts to gain stock control of Dodge." (Footnote omitted; emphasis added.)

"Arbitrary" standards have not prevented other courts from applying Section 16(b) to the substance of transactions before them, even where this has required extensive factual analysis of the circumstances of the transaction and of the intent of the insider as it bears thereon. "Arbitrary" standards have not deterred other courts from giving effect to the "broadly remedial" and "thoroughgoing" construction required under Section 16(b) by "strictly construing the statute against the insider in order to effectuate its wholesome purpose." *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 743 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). Factual analysis and remedial construction in cases involving the definitions of "purchase" and "sale" under Section 16(b) are familiar (see Part III below); moreover, the same responsibility to effectuate the statutory purpose has been exercised with respect to the very statutory standards, *i.e.*, insider status and the six-month

period, which the Eighth Circuit characterized as arbitrary.

Section 16(b) may not be extended to impose liability on those neither officers, directors nor 10% beneficial owners, *Blau v. Lehman*, 368 U. S. 403 (1962). But in *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970), the court found, only after extensive factual analysis, that Martin Marietta was a "director" of Sperry Rand for purposes of Section 16(b) through its deputy, George Bunker, who sat on the Sperry Rand board. Similarly, in *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967), the court construed the "10% beneficial owner" standard in the light of the statutory purpose of Section 16(b) as not applicable to the holder of more than 10% of a class of convertible debentures, even though the term literally applied. And in *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949), the court reversed a grant of summary judgment and remanded for full trial on the facts the question whether a corporate employee not holding the title of officer had such access to confidential corporate information that he should be deemed to be an "officer" for purposes of Section 16(b). The potential for unfair use of inside information, which in all these cases was the deciding factor, was ignored by the Eighth Circuit in the decision below.

"Less than six months" is an equally "arbitrary" standard, but "careful scrutiny" is required in any situation in which, as here, a statutory insider has shortened his period of investment risk to less than six months. In *Bershad v. McDonough*, 428 F.2d 693, 697 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971), the court was confronted with a "sale" which took place six months and one week after the purchase, and held that the grant of an option to purchase within the six-month period was a "sale" for pur-

poses of Section 16(b). In *Booth v. Varian Associates*, 334 F.2d 1, 4 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965), the question whether the statutory six-month period began with the signing of a contract to deliver shares or with their later delivery was resolved by analysis of the transaction to reach the result "most consonant with the statutory purpose." Here, where less than three months separated Emerson's only purchase from its final profitable sale, similar close analysis and remedial construction is required to prevent abuse.

Analysis of a transaction in the light of the purpose of Section 16(b) may require examination of the insider's intent. It is true that the intention of an insider to profit by unfair use of inside information, or to trade on a short swing, is irrelevant under Section 16(b). *Feder v. Martin Marietta Corp., supra*, 406 F.2d at 262. But what the insider intended his act or transaction to be is often an important factor in analyzing his act or transaction under Section 16(b). In *Martin Marietta*, the fact that the management of Sperry Rand and Martin Marietta intended that Bunker should act as Martin's deputy on the Sperry board was crucially relevant to the determination that Bunker was Martin's deputy. 406 F.2d at 265. As Judge Medina explained in *Truncale v. Blumberg*, 80 F. Supp. 387, 391-92 (S.D.N.Y. 1948), discussing the difference under Section 16(b) between a gift and a sale:

> It is argued that the statute was designed to operate irrespective of any intention on the part of the insider.
>
> . . . .
>
> But references in the cases to the operation of the statute irrespective of intention are plainly to the subject of intention to benefit by the use of inside information, see, e.g., Smolowe v. Delendo Corporation, 2 Cir., 1943, 136 F.2d 231, 235, 236, 148 A.L.R.

> 300, and the whole history of this legislation shows that the statutory scheme was deliberately designed to discourage short term speculation by insiders by eliminating the necessity of proof that there was an intentional and willful wrong by a profit-seeking fiduciary, unmindful of his duty. Hence no showing of an actual unfair use of inside information is required. *The intention now under discussion is of a different sort.* Whether a transaction is real or merely a device or artifice to avoid the impact of the statute must depend upon intention. By the application of familiar principles *the transaction falls into one category or another depending upon the intention of the parties.* (Emphasis added.)

Where, as here, the District Court found that Emerson intended "to dispose of its entire stock holdings pursuant to a plan" (A. 162), and concluded from this that "the two sales were in fact interrelated parts of a single plan" (A. 164), the reviewing court cannot dismiss the application of Section 16(b) to the entire plan by reference to "arbitrary standards."

The duty of a court when applying Section 16(b) cannot therefore be discharged by literal application of the statutory wording and a reference to the "arbitrary standards enacted by Congress." Particularly in a case in which a technique permitting obvious frustration of the statutory purpose is presented, like Emerson's two-step sale procedure, the substance of the transaction must be measured against the purpose of the statute taken as a whole, and the consequences of approval of a readily applicable technique of minimizing short-term profit recoveries must be taken into account. As Judge (now Mr. Chief Justice) Burger expressed it in *Adler v. Klawans,* 267 F.2d 840, 844 (2d Cir. 1959):

> In addition to the intent and purpose of the legislation which we must glean from the statute as a whole

> rather than from isolated parts, we must consider the results which would flow from each of the two interpretations contended for. If we find one interpretation tends to carry out and the other to defeat the purposes of the statute, the resolution of the issue becomes simple.

Within the statutory boundaries of Section 16(b) there have been and there remain many questions requiring statutory construction; the application of Section 16(b) to Emerson's two-step sale procedure is one such. The applicable rule of construction was stated in *Adler v. Klawans, id.* at 846-47, as follows:

> These prior holdings do not answer the problem presented here, but they do show a pattern of this court's view that the purpose of the statute is remedial, rather than penal, and that it must be strictly construed in favor of the corporation and against any person who makes profit dealing in the corporation stock. Of course, the statute cannot be extended beyond the limits of its language, but as we have pointed out above, the language, given a rational interpretation is broad enough to cover appellant's transaction in this instance.

As will be shown immediately below, a rational interpretation (indeed, the only acceptable interpretation) of Section 16(b)'s exemptive clause shows that it is inapplicable to the second sale of Emerson's two-step sale procedure. It follows that the decision of the Eighth Circuit as to Emerson's second sale should be reversed.

III. THE EXEMPTIVE PROVISION IN SECTION 16(b) DOES NOT EXEMPT THE SECOND OF TWO SALES EFFECTED PURSUANT TO A SINGLE PRE-DETERMINED PLAN OF DISPOSITION.

The Eighth Circuit held that Emerson's second sale fell literally within the language of Section 16(b) which provides that: "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale . . . ." We submit that the Eighth Circuit erred on two alternative grounds: first, it treated as two sales what should have been treated as one "sale" for purposes of Section 16(b), ignoring in its analysis the very findings of fact of the District Court which lead compellingly to the conclusion that one Section 16(b) "sale" took place; and second, it refused to approve the application of step transaction analysis and substance over form principles by which the District Court found in substance a single integrated disposition of stock by a 10% beneficial owner. More important than the technical analysis set forth in this Part III, of course, is the obvious fact that whatever the exemptive provision was intended to accomplish,[7] it could not have been intended by Congress to allow to 10% beneficial owners a readily available technique for taking the very short-term profits which the body of Section 16(b) so clearly prohibits. The technical analysis leads to the same conclusion.

---

[7] There is apparently no legislative history bearing on the exemptive clause, as it was added to the Act in late and closed drafting sessions. In an early article, Seligman, "Problems Under the Securities Exchange Act," 21 *Va. L. Rev.* 1, 20 (1934), Mr. Seligman hypothesized that "the intention of the language was to exclude the second sale in a case where 10% is purchased, 5% sold within three months and the remaining 5% a month later." Mr. Seligman did not opine on two sales within 8 days pursuant to a single pre-determined plan of disposition, a far different case.

A. Emerson's Two Sales Are To Be Treated as One "Sale" Under Section 16(b).

The thoroughgoing and remedial purpose of Section 16(b) has most often been furthered in judicial decisions by giving a broad interpretation to the terms "purchase" and "sale." The rule of construction was succinctly stated by Judge (now Mr. Justice) Stewart in *Ferraiolo v. Newman*, 259 F.2d 342, 345 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959): "Every transaction which can reasonably be defined as a purchase [or a sale] will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)." The two-step sale procedure is a transaction of this kind.

The Eighth Circuit believed that the District Court found "as a fact that Emerson made two separate sales not legally tied together in any way . . ." (A. 180), and based its holding, as a matter of law, upon that "finding of fact." The District Court found no such thing, as its Memorandum Opinion makes plain. When the District Court stated that "the second sale was not 'legally' tied in any way to the first sale" (A. 163), it used quotation marks to set off the word "legally," in a clear reference to the letter of Emerson's counsel which set forth the plan used by Emerson to "avoid the consequences" of Section 16(b). When the District Court found that the two sales were "technically separate transactions," it clearly meant that the sales were separate sales as a matter of contract law; but when analyzed under Section 16(b), the two technically separate transactions were found to be united as "interrelated parts of a single plan" (A. 164). Far from finding the sales not "legally" related, the District Court held that "the obvious substance" of Emerson's transaction was the disposition of Emerson's more than 10% interest (*Ibid.*).

In finding that Emerson's two sales should be treated as in substance one disposition or "sale" under Section 16(b), the District Court did not hold, nor has Reliance ever contended, that Emerson's first sale to Goldman, Sachs was a sham transaction; it was concededly a bona fide effective disposition of 37,000 shares of Dodge stock, under a separate contract, independent of Emerson's second sale to Dodge in all respects *except in respect of Section 16(b)*. As Emerson succinctly stated below (A. 168; emphasis added):

> The two sales were negotiated separately, at different times, by different representatives of Emerson, for different prices, to different purchasers having no connection or relationship with each other and, *except for the fact that they were made pursuant to Emerson's decision to dispose of its entire holdings of Dodge stock upon the most favorable terms,* were separate and distinct from each other in every respect.

The characterization of a transaction for local law purposes, however, does not conclude the characterization of the same transaction under Section 16(b). "The phrase 'any purchase and sale' in Section 16(b) is therefore not to be limited or defined solely in terms of commercial law of sales and notions of contractual rights and duties." *Bershad v. McDonough,* 428 F.2d 693, 697 (7th Cir. 1970), *cert. denied,* 400 U.S. 992 (1971). An exchange of shares of the acquired corporation for those of an acquiring corporation in a statutory merger is not a sale in any commercial or contractual meaning of the words; yet it was held a "sale" under Section 16(b) because unfair use of inside information was possible. *Newmark v. RKO General, Inc.,* 425 F.2d 348 (2d Cir.), *cert. denied,* 400 U.S. 854 (1970). The grant of an option to purchase shares is not a sale of those shares under corporate or stock trans-

fer law; yet, because insider abuse was possible, the grant was held a "sale" under Section 16(b). *Bershad v. McDonough, supra.* Where unfair use of inside information was possible, a voluntary conversion of convertible preferred stock into common stock was held a "purchase" of the common stock. *Park & Tilford v. Schulte,* 160 F.2d 984 (2d Cir.) *cert. denied,* 332 U.S. 761 (1947).

As shown above in Part II, what the insider intended his transaction to be is a relevant factor in determining how Section 16(b) applies to that transaction. Here Emerson intended "the disposition of its more than 10% beneficial interest" (A. 164) pursuant to a single plan. It carried out this disposition of Dodge stock by means of its two-step sale procedure. As shown in Part I above, the two-step sale procedure is capable of the abuse Section 16(b) was designed to prevent. Accordingly, the two-step sale procedure used by Emerson should be treated as one "sale" as the term is used in Section 16(b), and Emerson will have been a 10% beneficial owner of Dodge "at the time of" such sale.

Treating separate acts or contracts of disposition as one "sale" under Section 16(b) is not novel or unprecedented. In *Abrams v. Occidental Petroleum Corp.,* 323 F. Supp. 570, 574, 579 (S.D.N.Y. 1970), the findings of fact clearly indicate that Occidental purchased shares of Kern County Land Company at several different times from many different sellers between May 8 and June 8, 1967, pursuant to its tender offer; in its conclusions of law, the court held that: "The tender offer constituted a single act of Occidental, whereby the company became a beneficial owner of more than 10 percent of Old Kern's capital stock." Indeed, when Emerson purchased 152,282 Dodge shares on June 16, 1967, in its tender offer, each seller of Dodge stock to Emerson entered into a separate contract with Emerson by executing a letter of transmittal (A. 25);

yet Emerson has not contended that it made two or three thousand separate purchases rather than one "purchase" under Section 16(b). The view that several contractual transactions can constitute one "sale" under Section 16(b) was assumed without examination in *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100, 105 (S.D.N.Y. 1955), *affirmed in part*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956), where the trial judge stated:

> I pass to the question of the date of the sale. *The sale* of the 155,000 shares of Kaiser-Frazer stock *took place in three transactions*: a block of 10,000 shares was sold to one Frederick Lewisohn, a block of 45,000 shares was sold to investors through Otis & Company and a block of 100,000 shares was sold to Permanente Metals Corporation, a corporation substantially owned and controlled by Henry J. Kaiser. (Emphasis added.)

The District Court below applied Section 16(b) to Emerson's disposition as to a single transaction. The District Court recognized that any other result would "subvert the purposes of Section 16(b) and produce a result plainly at variance with its manifest policy" (A. 164). A proper ground for affirmance of the District Court and reversal of the Eighth Circuit, well-supported in prior decisions under Section 16(b), is the definition of Emerson's two-step sale procedure as a single "sale" as that term is defined in Section 16(b).

B. Section 16(b) Should Apply to Both of Emerson's Sales Transactions Under Substance Over Form Principles and the Step Transaction Doctrine.

The definition of "purchase" and "sale" under Section 16(b) and the application of those terms to Emerson's two-step sales technique is a particular application of general rules of statutory construction frequently referred to as the "substance over form" and the "step transaction" doctrines. The Eighth Circuit erred not only by failing to apply the principles of construction of the terms "purchase" and "sale" under Section 16(b), as discussed above, but also by failing to consider those broader principles, applied by the District Court, which provide an independent ground for concluding that Section 16(b) applies to Emerson's second sale.

It is a principle of general applicability that courts apply the law to the substance rather than to the form of transactions. This is what the District Court did below. Ten days after Emerson became a 10% beneficial owner of Dodge, Emerson's counsel wrote a letter to Emerson's Chairman of the Board which considered "principally, how to dispose of, at a profit, the shares of Dodge stock which Emerson now owns" (A. 33). The letter advised that "Emerson should proceed on the assumption that 16(b) does apply and should seek to avoid its consequences," and recommended as an "initial defensive step" that Emerson give away or sell 37,100 shares of Dodge stock, whereupon it could sell the balance "free of any 16(b) risk . . ." (A. 36). Emerson followed the plan so precisely that its first sale reduced its holdings to exactly 9.96% of the then outstanding shares of Dodge; and then Emerson promptly sold the balance. The District Court found that "the obvious substance" of Emerson's transaction was the disposition of its entire more than 10%

interest in Dodge, and, "looking through form to discern substance," applied Section 16(b) to the substantive single transaction it found (A. 174).

The Eighth Circuit seized upon the District Court's finding that the two sales were technically separate transactions, and did not otherwise deal with what the District Court found to be the substance of Emerson's two-step sale procedure, except to analogize Emerson's conduct to "tax avoidance conduct which is permissible" (A. 180). The Eighth Circuit cited only *Gregory v. Helvering*, 293 U.S. 465 (1935), in support of its view, thus curiously relying on the landmark federal income tax case applying the doctrine of substance over form. In *Gregory*, a transaction which concededly met all the literal statutory requirements for freedom from tax, as Emerson had met what it believed to be the literal statutory requirements for freedom from Section 16(b), was held not to be tax-free because the substance of the transaction was contrary to the intent of Congress as expressed in the statute as a whole. While *Gregory v. Helvering* may be read narrowly, as applying only to sham transactions having no non-tax reality, it has not in fact been so construed. Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 555, 605, 629 (2d Ed. 1966). At the very least, it has application to transactions which are not pure sham, but are devices to avoid a statutory liability; and if Emerson's first sale was not a sham, since it did constitute a bona fide arm's length disposition of Dodge stock, it was certainly and principally a device for facilitating later short-term profit-taking. The District Court expressly found that (A. 173): "Emerson's initial sale of 37,000 shares *was motivated solely* by its desire to reduce its holding to just under 10% immediately prior to disposing of the balance of its shares in an attempt to escape Section

16(b) liability on the short-swing profits it contemplated would be made upon such remaining shares." (Emphasis added.) In applying a statute which is to be broadly and remedially construed against the insider, intentional avoidance of statutory liability cannot be permitted.

An application of substance over form principles which does not require a finding that a transaction involved sham or subterfuge is the step transaction doctrine. Under this rule, a person will not be allowed to separate an integrated transaction into two distinct steps, each of which, when taken separately, is permissible, to escape the legal consequences which would attach to the transaction if done in one step. The District Court applied this rule to Emerson's two-step sale procedure (A. 174); the Eighth Circuit, erroneously, we submit, did not.

The step transaction doctrine is well established in the field of Federal income taxation, where the term "step transaction" refers to a group of closely related rules, varying formulations of which are applicable in various substantive areas of tax law. A careful analysis of the doctrine is found in *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). There it is pointed out that while one formulation of the step transaction doctrine requires that the steps be so interdependent that the legal relations created by the first step would be fruitless without completion of the series, *cf. American Bantam Car Co.*, 11 T.C. 397 (1948), *affirmed*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950), there is another and broader formulation, where steps not fruitless standing alone will be treated as a single transaction if it appears that they were really component parts of a larger transaction intended from the outset to reach the ultimate result, *cf. Anheuser-Busch, Inc. v. Helvering*, 40 B.T.A. 1100 (1939), *affirmed*, 115 F.2d 662 (8th Cir.

1940), *cert. denied*, 312 U.S. 699 (1941). In *King Enterprises*, the broader "end result" test was applied; it was pointed out that the vitality of the doctrine depends upon its broad construction, and that the reference to "binding commitment" in *Commissioner v. Gordon*, 391 U.S. 83 (1968), cannot have been intended to permit avoidance of the step transaction rule. See also *United States v. General Geophysical Co.*, 296 F.2d 86 (5th Cir.), *rehearing denied*, 62-1 U.S.T.C. ¶ 9115 (5th Cir. 1961), *cert. denied*, 369 U.S. 849 (1962), in which the court held that two transactions concededly not connected by a "binding commitment" or independently "fruitless" should be treated as one for tax purposes, and on rehearing pointed out in great detail how application of the step transaction doctrine was perfectly consistent with treatment of the two transactions as fully valid and independently effective for all state law purposes.

The step transaction doctrine in its broadest form is well established in Federal securities law. In *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558, 562 (S.D.N.Y. 1957), *affirmed sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959), the court held that the "no sale" exemption provided in Rule 133 was inapplicable to the exchange of Converters assets for Micro-Moisture stock, even though the Rule had been literally complied with, because the exchange "was but a step in the major activity of selling the stock." See also *Great Sweet Grass Oils Ltd.*, 37 S.E.C. Reports 683 (1957), *affirmed*, 256 F.2d 893 (D.C. Cir. 1958). Similarly, in *The Crowell-Collier Publishing Co.*, Securities Act Release No. 3825 (1957), 1957-61 CCH Fed. Sec. L. Rep. ¶ 76,539 at p. 80,131, the Securities and Exchange Commission stated:

> Through these purported private offerings of debentures, options and warrants the company has accomplished and continues to accomplish by indirection that which it concluded early in 1955 could not be done directly: namely, obtaining substantial additional capital from the sale to the public of equity securities.
>
> It has been and is the Commission's position that an issuer or an underwriter *may not separate parts of a series of related transactions* comprising an issue of securities and thereby seek to establish that a particular part is a private transaction if the whole involves a public offering of the securities. (Emphasis added.)

Separating "parts of a series of related transactions" is precisely what Emerson did. The District Court below found as a fact that Emerson's two sales transactions were "related parts of a single plan devised by Emerson to dispose of all its Dodge stock in an attempt to 'avoid the consequences' of Section 16(b)" (A. 164). The Eighth Circuit accepted this finding (A. 180). The District Court applied the step transaction rule, holding that Emerson could not "excise Section 16(b) liability or 'avoid its consequences' by utilizing a series of related transactions, some of which considered separately might be exempt, when the obvious substance of the transaction as to a whole is the disposition of its more than 10% beneficial interest" (A. 164). The Eighth Circuit refused to apply the step transaction doctrine, thus creating a significant exception to the theretofore thoroughgoing and remedial scope of Section 16(b). If the step transaction doctrine is applicable under Federal income tax law and under the Securities Act of 1933, it should *a fortiori* be applicable under the remedial provisions of Section 16(b). We submit that the Eighth Circuit erred.

IV. SECTION 16(b) SHOULD BE CONSTRUED AS BROADLY AS POSSIBLE TO MAINTAIN FIDUCIARY STANDARDS.

When it decided to purchase 152,282 shares of Dodge stock from Dodge shareholders on June 16, 1967, Emerson elected to become a "statutory fiduciary" of Dodge. *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 742 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). As Judge Learned Hand stated in *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951), "Section 16(b) in effect made 'beneficial owners' fiduciaries as directors and officers were anyway." As a statutory fiduciary of Dodge, Emerson reaped substantial profits on the sale of those Dodge shares in less than three months. In its review of the decision of the Eighth Circuit, this Court will set forth standards of conduct which will guide other statutory fiduciaries under Section 16(b).

The classic statement of the standard of fiduciary conduct, repeatedly held applicable to statutory fiduciaries under Section 16(b) (*Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); *Blau v. Lehman*, 368 U.S. 403, 416-20 (1962) (Mr. Justice Douglas, dissenting); *Volk v. Zlotoff*, 285 F. Supp. 650, 656 (S.D.N.Y. 1968)), is that of Chief Judge Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928):

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising

> rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. *Wendt v. Fischer,* 243 N.Y. 439, 444, 154 N.E. 303. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

By its two-step sale procedure, Emerson made and kept substantial short-swing profits. The ultimate question presented here is whether Emerson is entitled to retain those profits. In the first case to arise in the federal courts construing Section 16(b), *Smolowe v. Delendo Corp., supra,* 136 F.2d at 239, the Second Circuit Court of Appeals determined that:

> . . . [T]he statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty.

The decision of the Eighth Circuit below permitted Emerson to retain the major portion of its short-swing profits, and approves a technique whereby other statutory fiduciaries can make and keep profits by careful arrangement of the form of their transactions. We submit that, to maintain well-established standards of fiduciary conduct under Section 16(b), the decision of the Eighth Circuit on Emerson's second sale must be reversed.

CONCLUSION.

The Court should reverse the judgment of the Eighth Circuit Court of Appeals on Emerson's second sale, and should affirm the judgment of the District Court and remand the cause for a determination of the amount of profits involved.

Respectfully submitted,

THOMAS P. MULLIGAN,
PATRICK J. AMER,
1750 Union Commerce Building,
Cleveland, Ohio 44115,

STEPHEN J. BURNS,
24701 Euclid Avenue,
Cleveland, Ohio 44117,

KENNETH S. TEASDALE,
611 Olive Street,
St. Louis, Missouri 63101,
Counsel for Petitioner.

Of Counsel:

JONES, DAY, COCKLEY & REAVIS,
ARMSTRONG, TEASDALE, KRAMER & VAUGHAN.